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No. 479

In the Supreme Court of the United States

OCTOBER TERM, 1939

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES A. BRUUN

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 30) is unreported. The opinion of the Circuit Court of Appeals (R. 43–46) is reported at 105 F. (2d) 442.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 24, 1939 (R. 46–47). The petition for a writ of certiorari was filed October 21, 1939, and was granted November 22, 1939. The jurisdiction of this Court is conferred by Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a lessor derives income in the year of the cancellation of a lease to the extent of the then value of a building erected by the lessee and forfeited to the lessor upon the termination of the lease because of its breach.

STATUTE AND REGULATIONS INVOLVED

The relevant statute and regulations are set out in the Appendix, *infra*, pp. 27–30.

STATEMENT

The facts were stipulated (R. 13–30) and they may be summarized as follows.

The taxpayer, at all times material here, owned a lot in Kansas City, Missouri. On July 1, 1915, he leased the lot for a term of 99 years to the Newmarket Investment Company. At the time of the execution of the lease there was a building upon the property which had an undepreciated cost to the taxpayer of $13,365. During the year 1929 the lessee, as it was permitted to do under the lease, demolished and removed the building from the premises and during that same year it constructed a new building, which had a useful life of not more than fifty years (R. 14).

On July 1, 1933, the lessee being in default in the payment of rent and taxes, the lease was

cancelled and the property, together with the buildings then thereon, turned over to the taxpayer. On that date the building which had been erected by the lessee had a fair market value of $64,245.68 and the unamortized cost of the old building removed by the lessee in 1929 was $12,811.43, leaving an excess of $51,434.25 in the fair market value of the new building as of July 1, 1933, the date the lease was cancelled (R. 14).

The Commissioner of Internal Revenue determined that the taxpayer, as a result of the termination of the lease, realized a net gain of $51,434.25, being the difference between $64,245.68, the value of the new building, and $12,811.43, the adjusted cost base of the old building (R. 15). The Board of Tax Appeals held that no gain was realized in 1933 (R. 30), and the Circuit Court of Appeals affirmed (R. 46).

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

1. In holding that no taxable income resulted to the taxpayer in the year 1933 upon the premature termination of the lease, and his acquisition of the property including a building erected thereon by the lessee.

2. In failing to hold that the taxpayer realized a net taxable income in the amount of $51,434.25 during the year 1933 by reason of the termination of the lease by cancellation and his acquisition of

possession of the property including the building erected thereon by the lessee.

3. In affirming the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

I

The problem of how to tax the admitted gain which accrues to a lessor as a result of improvements made by the lessee has had a long administrative and judicial history. In 1917 the Treasury ruled that the improvements constitute income to the lessor upon termination of the lease, after deducting a reasonable amount for depreciation, etc. That ruling was incorporated in the two succeeding editions of the Treasury Regulations. Thereafter, it was held in *Miller* v. *Gearin,* 258 Fed. 225 (C. C. A. 9th), that the rule so embodied in the regulations was invalid. The court said that the gain, if taxable at all, must be reported when the improvements were first completed and title passed to the lessor. This Court denied certiorari, 250 U. S. 667.

The Treasury Department thereupon amended its regulations to conform to that decision. Under the new practice, a tax was imposed upon the gain in the year the improvements were completed, measured by their anticipated value at termination of the lease and discounted for the term of the lease. The lessor was later given the option of spreading the depreciated value of the improvements over the

remaining life of the lease, reporting an aliquot part each year, and, upon premature termination, provision was made for the imposition of a tax upon the excess of the then value of the improvements over the amount theretofore reported.

Subsequently, after a lapse of about fifteen years, the new regulations were declared invalid in *Hewitt Realty Co.* v. *Commissioner,* 76 F. (2d) 880 (C. C. A. 2d), and in *M. E. Blatt Co.* v. *United States,* 305 U. S. 267, as applied to a tax for a year prior to termination of the lease. The Court in the *Blatt* case stated (p. 280) that the lessor "had no right to use or dispose" of the improvements during the term of the lease, and that "Mere acquisition of that sort did not amount to contemporaneous realization of gain." The Court left open the question here presented, namely, whether taxable gain is realized upon termination of the lease, when the lessor comes into unfettered possession of a new and valuable asset.

II

It is the Government's position that the gain here in question comes within the broad sweep of the all-inclusive definition of gross income contained in Section 22 (a) of the Revenue Act of 1932. That definition is coextensive with the power of Congress under the Constitution, and the tax can be invalid only if it exceeds a constitutional limitation.

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It seems plain that there can be no constitutional objection to the tax here involved. *Eisner* v. *Macomber*, 252 U. S. 189, held that income must be "realized" to be taxable, and that common stock dividends paid on common stock are not income because the stockholder has not "received" anything. Here, however, the lessor has received something new. He has come into possession of a substantial and valuable building. It would be sheer sophistry to assert that he has not acquired something new and valuable. The decisions of this Court, both before and after *Eisner* v. *Macomber*, make it clear that income may be received in the form of property. And it is immaterial that the gain is affixed to the taxpayer's preexisting capital. In the case of exchanges of property, taxable income may unquestionably be realized, even though the gain is inextricably bound up in the property received in exchange. Subsequent resale has never been deemed necessary in order to impose the tax under those circumstances, and it should be no more essential here.

ARGUMENT

I

INTRODUCTORY—THE PROBLEM AND ITS HISTORY

The problem of how to tax the admitted gain which accrues to a lessor as a result of improvements made by the lessee has long been a troublesome one. On February 6, 1917, the Treasury ruled that the improvements constituted income to

the lessor upon termination of the lease. T. D. 2442, 19 Treas. Dec. Int. Rev. 25.[1] The amount taxable was not the full cost of the improvements, but rather that amount less a reasonable allowance for depreciation, etc. This ruling was then incorporated, with some modification not material here, in the 1918 edition of Regulations 33, Article 4, par. 50, and in the 1919 edition of Regulations 45, Article 48.

Shortly thereafter, the Circuit Court of Appeals for the Ninth Circuit held those regulations invalid. *Miller* v. *Gearin*, 258 Fed. 225. The court said that the lessor realized no taxable income upon termination of the lease, and that the gain represented by the new building, if taxable at all, must be taxed when the building was first completed and title passed to the lessor (p. 226). This Court denied the Government's petition for certiorari. 250 U. S. 667.

The Treasury Department thereupon undertook to accommodate itself to that decision. It amended its practice, and ruled that income was realized in the year the improvements were added, taxable in the amount of their fair market value subject to the lease. T. D. 3062, 3 Cumulative Bulletin 109, later embodied in the 1920 edition

[1] Prior to this Treasury Decision there had been in effect a somewhat ambiguous ruling that amounts so expended by the lessee were taxable to the lessor in the year in which the benefits "accrued to the landlord." T. D. 2135, 17 Treas. Dec. Int. Rev. 39, 44–45, issued January 23, 1915.

of Regulations 45, Article 48. The new ruling also made provision for the imposition of an additional tax at the premature termination of the lease to the extent that the value of the improvements at such termination should exceed the income originally reported, subject to the condition, however, that such excess should not include any appreciation in value due to causes other than premature termination.[2]

The new ruling occasioned by *Miller* v. *Gearin* was continued and amplified in the regulations promulgated under the Revenue Act of 1921. Article 48 of Regulations 62 (1921 Act) gave the lessor the option of reporting the value of the improvements subject to the lease in full when they were added, or to spread the depreciated value of the improvements over the life of the lease, reporting an aliquot part each year. And these provisions thereafter reappeared from time to time with various modifications and enlargements in the regulations issued under the succeeding revenue acts.[3]

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[2] The fact that the change in practice was made in response to judicial decision is fully explained in Mim. 2714, 4 Cumulative Bulletin 90. In accord with *Miller* v. *Gearin*, at that time was *Cryan* v. *Wardell*, 263 Fed. 248 (N. D. Cal.).

[3] Regulations 65 (1924 Act), Article 48; Regulations 69 (1926 Act), Article 48; Regulations 74 (1928 Act), Article 63, as amended by T. D. 4539, XIV–1 Cumulative Bulletin 141; Regulations 77 (1932 Act), Article 63, as amended by T. D. 4539, XIV–1 Cumulative Bulletin 141; Regulations 86 (1934 Act), Article 22 (a)–13; Regulations 94 (1936 Act), Article 22 (a)–13; Regulations 101 (1938 Act), Article 22 (a)–13.

The new practice, initiated after *Miller* v. *Gearin*, continued without any serious challenge for about fifteen years[4] until 1935 when the Circuit Court of Appeals for the Second Circuit declared the new regulations invalid, and struck down a tax for a year prior to the termination of the lease. *Hewitt Realty Co.* v. *Commissioner*, 76 F. (2d) 880.

Thereafter, during the 1938 term of this Court, it was held that the lessor could not be taxed upon improvements made by the lessee where the lease had not yet expired, *M. E. Blatt Co.* v. *United States*, 305 U. S. 267, thus likewise invalidating the regulations which had been adopted to reflect the result reached in *Miller* v. *Gearin*. The Court said (p. 280):

> It may be assumed that, subject to the lease, lessor became owner of the improvements at the time they were made. But it had no right to use or dispose of them during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute.

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[4] The issue was not raised very often, but whenever the occasion presented itself the new practice was always mentioned with approval. *United States* v. *Boston & Providence R. R. Corp.*, 37 F. (2d) 670, 672 (C. C. A. 1st); *Crane* v. *Commissioner*, 68 F. (2d) 640, 641 (C. C. A. 1st); *Kentucky Block Coal Co.* v. *Lucas*, 4 F. Supp. 266, 268 (W. D. Ky.); *Brown* v. *Commissioner*, 4 B. T. A. 1129; *Crosby* v. *Commissioner*, 4 B. T. A. 1147; *Scott* v. *Commissioner*, 9 B. T. A. 1219; *Alexander* v. *Commissioner*, 13 B. T. A. 1169; *Cataract Ice Co.* v. *Commissioner*, 23 B. T. A. 654; *Martin* v. *Commissioner*, 24 B. T. A. 813.

It refused to state whether improvements made by a lessee could constitute income to the lessor upon termination or at any other time (p. 276).[5]

The *Blatt* case thus left open the question, previously decided against the Government in *Miller* v. *Gearin*, whether the lessor realizes taxable income at the termination of a lease when he comes into possession of a valuable building constructed by the lessee. The court below in the instant case therefore erred in invoking the *Blatt* case as controlling here (R. 46). And in *Commissioner* v. *Wood*, (C. C. A. 7th), decided November 27, 1939, not yet officially reported but found in 1939 C. C. H., Vol. 4, p. 10919, involving a similar situation, the court, although deciding in favor of the taxpayer, nevertheless plainly stated:

> * * * we do not believe as does the court in the *Bruun* case that *M. E. Blatt Co.* v. *United States, supra,* is controlling.

It is our position that upon termination of the lease, the lessor realized taxable income since he actually received something new and was enriched to that extent. Section 22 (a) of the Revenue Act of 1932 is broad and all inclusive in its terms. We contend that it embraces the present situation.

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[5] Mr. Justice Stone concurred specially upon the ground that the findings failed to establish that the improvements involved produced any increase in the value of the taxpayer's property.

Our position is, therefore, substantially the same as that which we unsuccessfully sought to establish in *Miller* v. *Gearin*.[6]

II

THE LESSOR REALIZED TAXABLE INCOME UPON TERMINATION OF THE LEASE

1. Section 22 (a), in defining gross income, is all inclusive. In its broad sweep, Congress intended to make that definition co-extensive with its power under the Constitution. *Helvering* v. *Stockholms &c. Bank*, 293 U. S. 84, 89; *Douglas* v. *Willcuts*, 296 U. S. 1, 9; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88, 89; *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 223; *Irwin* v. *Gavit*, 268 U. S. 161, 166. The scheme of the revenue acts is to tax *all* income,

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[6] The authority of *Miller* v. *Gearin* appears to have been somewhat impaired by this Court's decision in the *Blatt* case. In *Miller* v. *Gearin* the court supported its decision partly on the ground that if income is realized at any time from the construction of improvements it is realized immediately upon construction. This Court, in the *Blatt* case, rejected the view that the mere installation of improvements on land subject to a continuing lease may give rise to taxable income.

There is, however, one difference between this case and *Miller* v. *Gearin* that the court in the latter case might have regarded as crucial; namely, that title to the building, in *Miller* v. *Gearin* passed to the lessor immediately upon its construction, whereas in the instant case title did not pass until termination of the lease (R. 45). But the *Blatt* case expressly made immaterial the date when title passed. 305 U. S. at 280.

except to the extent that the statute specifically excludes any particular type of income. The gain to the lessor in the present case does not fall within any of those exclusions, nor does respondent contend that it does. The only ground upon which the tax is assailed is that the gain is not comprehended within Section 22 (a) itself. This is really a question of constitutional law, for, as pointed out above, the broad sweep of Section 22 (a) was intended to embrace every kind of gain or profit within the power of Congress. Any other view would produce hopeless confusion in the administration of the revenue laws; for there would result a no man's land between the external boundaries of the statutory and constitutional definitions of income—an area that would defy any intelligent effort at delimitation. The statutory definition of income is so broad and sweeping that it would require the most specious reasoning to place any gain or profit beyond its scope and yet within the definition of income as used in the Constitution.

If this problem is to be approached realistically, therefore, it must be recognized that the true question before the Court is whether the admitted gain which accrued to the lessor can be taxed to him under the Constitution. This was the problem as it was understood by Judge Learned Hand in *Hewitt Realty Co.* v. *Commissioner*, 76 F. (2d) 880,

884 (C. C. A. 2d), and it was in reliance upon the supposed constitutional requirement of "realization" set forth in *Eisner* v. *Macomber*, 252 U. S. 189, that the tax in the *Hewitt Realty Co.* case was declared invalid.

2. It seems clear that there is no constitutional objection to a tax upon the gain which accrues to the lessor upon the termination of the lease when he comes into possession of a newly constructed building. *Eisner* v. *Macomber* held that a dividend of common stock upon common stock could not be taxed as income, because the majority of the Court felt that the stockholder received nothing, that there had been no "realization." But, regardless of the soundness of *Eisner* v. *Macomber*, it is quite clear that where the stockholder receives stock of a different class, or stock which changes his relative position in the corporation, he has "realized" income.[7] And it is settled beyond question that income may be received in the form of property without the necessity of any subsequent sale. *Peabody* v. *Eisner*, 247 U. S. 347. The *Macomber* decision expressly left this result undisturbed (252 U. S. at 215), and it has been applied in a wide

[7] *Koshland* v. *Helvering*, 298 U. S. 441; *Helvering* v. *Gowran*, 302 U. S. 238. Cf. *Helvering* v. *Pfeiffer*, 302 U. S. 247. In these cases, however, the stock dividends involved were not taxed when received because of an express statutory exemption.

variety of situations.[8] The Revenue Acts[9] as well as the Treasury Regulations have long recognized that income may be received in the form of property.[10] Indeed, even the *purchase* of property at

[8] E. g., *United States* v. *Phellis*, 257 U. S. 156 (securities received pursuant to reorganization); *Marr* v. *United States*, 268 U. S. 536 (same); *Rockefeller* v. *United States*, 257 U. S. 176 (same); *Cullinan* v. *Walker*, 262 U. S. 434 (same); *James* v. *Commissioner*, 13 B. T. A. 764, affirmed on other issues, 49 F. (2d) 707 (C. C. A. 2d) (dividend paid in Liberty Bonds); *T. C. Power & Brother* v. *Commissioner*, 6 B. T. A. 835, appeal dismissed on procedural point, 27 F. (2d) 116 (C. C. A. 9th) (accounts receivable distributed as dividend); *Castle* v. *Commissioner*, 9 B. T. A. 931 (corporation gave lands to stockholder in return for bonds of lesser value); *Owen* v. *Commissioner*, 3 B. T. A. 905 (stock in other corporation distributed as dividend).

[9] Section 22 (a) of the Revenue Act of 1932, c. 209, 47 Stat. 169, defines "gross income" as including, *inter alia*, gains, profits, and income from salaries, wages or compensation for personal service, "of whatever kind and *in whatever form paid*." (Italics supplied.) "Dividends," also included in Section 22 (a), is defined in Section 115 (a) as "any distribution made by a corporation to its shareholders, whether in money or in other property." Similar provisions appear in Sections 22 (a) and 115 (a) of the Revenue Acts of 1928, c. 852, 45 Stat. 791, and Sections 213 (a) and 201 (a) of the Revenue Acts of 1926, c. 27, 44 Stat. 9; 1924, c. 234, 43 Stat. 253; 1921, c. 136, 42 Stat. 227; and 1918, c. 18, 40 Stat. 1057.

[10] Article 51 of Regulations 77, pertaining to the Revenue Act of 1932, provides: "Income may be in the form of cash or of property." Article 53 provides: "Where services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income." The identical provisions appear in Articles 51 and 53 of Regulations 74, pertaining to the Revenue Act of 1928, Articles 31 and 33 of Regulations 69, pertaining

a price substantially less than its fair market value may, under certain circumstances, be treated as an income producing transaction. See Regulations 77, Article 51;[11] *Salvage* v. *Commissioner*, 76 F. (2d) 112, 114 (C. C. A. 2d), affirmed, 297 U. S. 106; cf. *Elverson Corporation* v. *Commissioner*, 40 B. T. A. 614. In this situation, as in the case of the exchange of property, the absence of a sale and the fact that capital and gain are embodied in a single asset do not preclude realization.

Moreover, taxable income may be realized when neither money nor property is received. The requirement of realization has been deemed complied with by this Court upon the receipt of such benefits as the payment of taxpayer's indebtedness,[12] or

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to the Revenue Act of 1926, Articles 31 and 33 of Regulations 65, pertaining to the Revenue Act of 1924, and Articles 31 and 33 of Regulations 45, pertaining to the Revenue Act of 1918. Article 31 of Regulations 62, pertaining to the Revenue Act of 1921, is also identical with Article 51 of Regulations 77.

[11] Article 51 of Regulations 77 contains the following provision: "Where property is sold by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value." See also A. R. R. 6940, III-1 Cum. Bull. 32 (1924); I. T. 3204, 1938-2 Cum. Bull. 126; Regulations 77, Article 193.

[12] *United States* v. *Hendler*, 303 U. S. 564; *Duffin* v. *Lucas*, 55 F. (2d) 786 (C. C. A. 6th), certiorari denied, 287 U. S. 611.

taxes,[13] the satisfaction of other obligations,[14] or even the discharge of a mere "social duty."[15] Similarly, the release of funds from devotion to a specific liability to the general uses of the taxpayer, thus increasing "free" assets, may give rise to taxable income.[16]

Realization of income also occurs when taxpayer purchases its own obligations at less than the amount received for them. *United States* v. *Kirby Lumber Co.*, 284 U. S. 1. The doctrine of the *Kirby Lumber* case has been extended to a situation in which the taxpayer's obligations were originally issued for property rather than money. *Helvering* v. *American Chicle Co.*, 291 U. S. 426. In that case, when the obligations were later discharged for less than par, the difference was held to constitute realized income, not a mere reduction in the purchase price of the property with no realization of gain until disposition of the property acquired, as the lower court there had held.[17]

In *Eisner* v. *Macomber*, the stock dividend was held nontaxable because the Court thought that the stockholder had not *received* anything. Although the result reached in the *Macomber* case is at best

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[13] *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716.

[14] *Douglas* v. *Willcuts*, 296 U. S. 1; *Helvering* v. *Schweitzer*, 296 U. S. 551; *Helvering* v. *Blumenthal*, 296 U. S. 552.

[15] *Burnet* v. *Wells*, 289 U. S. 670.

[16] See *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 352–353.

[17] *Commissioner* v. *American Chicle Co.*, 65 F. (2d) 454 (C. C. A. 2d).

doubtful, as may be seen from the vigorous dissents of Justices Holmes, Day, Brandeis, and Clarke, the present case is nevertheless sharply distinguishable.

The gain to the lessor was attributable to no mere enhancement in value of an existing asset. He actually received something new. He came into possession of his property and found a new and valuable building thereon. There can be no question as to its worth, for it is stipulated that it had a fair market value of $64,245.68. To say that the lessor has not received anything is to fly in the face of plain fact. He has been enriched, and has come into unfettered possession of a building which he did not own at the beginning of the lease. In the *Blatt* case, this Court held that no income accrued to the lessor so long as the lessee remained in possession. But here the lease has been forfeited and the lessor has come into full possession and enjoyment of the building, released from the rights previously enjoyed by the lessee.

Plainly, if the lessor succeeded to personal property which the lessee had been compelled to leave behind, he would have realized taxable income. Yet merely because the property here is affixed to the realty, and is therefore in the nature of real property itself, it is said that no income has been "realized" until the property is sold.[18] It is in-

[18] If the Government is compelled to await sale or final disposition of the property, then the gain involved will never be taxed in full, if at all. For the property will undoubtedly depreciate in value pending sale or disposition and such

conceivable that any such tenuous distinction was ever intended by the use of the word "income" in the Sixteenth Amendment.

Although the *Macomber* case pointed out (252 U. S. at 207) that income is gain "derived" from capital, and that it is something received by the taxpayer "for his *separate* use, benefit and disposal", it is immaterial that the income here (the building) was attached to and inseparable from the capital (the land). For it is firmly established that taxable income may be realized where property or securities are exchanged for other property or securities. *Cullinan* v. *Walker,* 262 U. S. 134; *Marr* v. *United States,* 268 U. S. 536. Yet in that situation there is inextricably combined in the property received both taxpayer's capital and the gain admittedly derived therefrom. In the present case, while the building received may not, as a practical matter, be readily capable of sale apart from the land, and while for purposes of real property law the land and the building are merged in one title, it is manifest that they are visibly separate and distinct physical assets. They were acquired at different times, from different sources, and by dissimilar

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decrease will probably be reflected in the sale price, thus diminishing or even entirely eliminating the amount of taxable income attributable to the lessee's improvements. Meanwhile, however, pending such sale or disposition, the lessor will have the full enjoyment of such property, just as if he had received the full amount in cash and invested it in such improvements himself.

transactions. Moreover, the obvious physical distinction between them is reflected in separate valuation for purposes of local taxes and in different treatment for purposes of depreciation and obsolescence in federal income tax law. Indeed, as was pointed out in *Commissioner* v. *Center Investment Co.* (C. C. A. 9th), decided November 27, 1939, not yet reported officially but found in 1939 C. C. H., Vol. 4, p. 10,927, 10,928, title to land and to the building upon it may be vested in different persons. *Fairbanks* v. *S. F. & N. P. Ry. Co.*, 115 Cal. 579, 583–584; cf. *Lillibridge* v. *Lackawanna Coal Co.*, 143 Pa. 293.

3. In deciding against the Government, the court below relied upon the *Blatt* case as controlling (R. 46). But, as we have already endeavored to show, *supra*, pp. 9–10, the *Blatt* case merely held that no income was realized by the lessor *prior* to termination of the lease, since the lessor "had no right to use or dispose of them [improvements] during the term", and there was accordingly no "contemporaneous realization of gain." 305 U. S. at 280. Moreover, as this Court was careful to point out, the findings in the *Blatt* case failed to show that the so-called improvements made by the lessee increased the value of the property (305 U. S. at 278–279), and it was upon this basis that Mr. Justice Stone concurred. The question whether a new building constructed by the lessee which became the property of the lessor subject to his unrestricted use at the termination of the lease constitutes tax-

able income to the lessor at such termination was not decided in the *Blatt* case. 305 U. S. at 276–277. That is the question for decision here.

It is true that there is some language in the *Blatt* opinion which, when considered apart from the facts there before the Court, would appear to give color to respondent's position here. The Court said (p. 279):

> Granting that the improvements increased the value of the building, that enhancement is not realized income of lessor. So far as concerns taxable income, the value of the improvements is not distinguishable from excess, if any there may be, of value over cost of improvements made by lessor. * * *

The Court plainly could not have intended that language to be taken at its face unrelated to the facts *sub judice*. There is no mere enhancement in value in this case. The lessor has actually received something of considerable value. And that clear gain is income in its truest sense, income that was realized upon cancellation of the lease.

However, if that language is to read literally, then we respectfully ask that it be reconsidered. Of course, a lessor does not realize income when he expends money to make improvements on his own property; he merely makes a capital investment and derives no gain therefrom. But here the improvements were made by the lessee and actually enriched the lessor. The gain was realized upon forfeiture of the lease, when the

lessor for the first time obtained the unrestricted use of the new building. The situation should not be confused by labeling that gain as an addition to "capital." In a sense, whenever an asset is sold or exchanged for consideration in excess of its cost or other basis there is a "capital gain." Yet it is clear beyond question that a realized capital gain constitutes taxable income. And it is equally clear that a sale is not essential to realization, since income may be realized in a variety of ways including the receipt of property.

Hewitt Realty Co. v. *Commissioner*, 76 F. (2d) 880 (C. C. A. 2d), relied upon by the court below, merely held, as did the *Blatt* case, that improvements made by the lessee do not constitute taxable income in a year prior to termination of the lease.[19] Although the case is thus distinguishable upon its

[19] The case is further distinguishable in that, by the terms of the lease, lessee had a contingent option to renew for three successive periods of 21 years. The Commissioner added to taxpayer's income the aliquot part of the depreciated value of the building for the year in question on the assumption that the controlling term of the lease was 21 years. As was pointed out in the separate opinion of Judge Chase, page 883, the option of renewal "put it in the power of the lessee to deprive the lessor of possession and control of the building during all the time it had value." Even renewal for one term would have put the date of termination beyond the agreed depreciated life of the building. For that reason, Judge Chase believed the Commissioner's determination was erroneous. The prevailing opinion likewise adverted to the possibility of the lessee's renewal, which it regarded as an additional support for its conclusion that no taxable income had been realized (p. 885).

facts, the criterion of realization adopted by the majority is nevertheless contrary in the main to our present position. Under their view (p. 884), no income is realized unless the "value received is embodied in something separately disposable." Therefore, according to their view the gain represented by the building could not be taxed until the property is sold, and the result was placed squarely upon constitutional grounds. But we have already discussed the fallacy of the theory that there is a constitutional impediment which forbids the tax, and respectfully submit that Judge Chase's separate opinion in the *Hewitt Realty* case represents the correct view in this respect. The theory expounded by Judge Learned Hand for the majority, which we believe to be unsound, has since been adopted in a number of cases in the Board as well as in other federal courts.[20] In view of its drastic character, relying upon specious constitutional grounds to invalidate a tax upon clear gain,

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[20] *Nicholas* v. *Fifteenth Street Inv. Co.*, 105 F. (2d) 289 (C. C. A. 10th); *Commissioner* v. *Wood* (C. C. A. 7th), decided November 27, 1939, not yet officially reported but found in 1939 C. C. H., Vol. 4, p. 10,919; *Commissioner* v. *Center Investment Co.* (C. C. A. 9th), decided November 27, 1939, not yet officially reported but found in 1939 C. C. H., Vol. 4, p. 10,927; *English* v. *Bitgood*, 21 F. Supp. 641 (Conn.); *Marshall* v. *Glenn* (W. D. Ky.), decided February 17, 1939, not officially reported but found in 1939 C. C. H., Vol. 4, p. 9694; *Dominick* v. *United States*, 24 F. Supp. 829 (S. D. N. Y.); *Staples* v. *United States*, 21 F. Supp. 737 (E. D. Pa.); *Hilgenberg* v. *United States*, 21 F. Supp. 453 (Md.); *Cleveland Trust Co.* v. *Commissioner*, 39 B. T. A. 113;

and in view of its widespread acceptance among the lower tribunals, including the court below, we respectfully ask that it be specifically disapproved.

4. We have contended that the gain to the lessor is embraced within the all-inclusive definition of gross income which is coextensive with the meaning of "income" as used in the Sixteenth Amendment, and we have undertaken to show that the gain here in question is within the terms of the Sixteenth Amendment. However, in order to dispel any possible confusion, we believe that it will be helpful to consider briefly the precise nature of the Sixteenth Amendment, and its relationship to the taxing power.

The basic power of Congress to levy taxes is derived from Article I, Section 8, Clause 1 of the Constitution, which provides:

> The Congress shall have power to lay and collect taxes, duties, imposts, and excises, to

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Merkra Holding Co. v. *Commissioner*, 39 B. T. A. 117; *Stimson Corp.* v. *Commissioner*, 38 B. T. A. 303; *Durkheimer Investment Co.* v. *Commissioner*, 36 B. T. A. 423; *Brookside Realty Co.* v. *Commissioner*, Memorandum Opinion, B. T. A., March 20, 1939 (pending C. C. A. 2d); *The Hills Corp.*, Memorandum Opinion, B. T. A., March 27, 1939 (pending C. C. A. 10th); *Heppenheimer* v. *Commissioner*, Memorandum Opinion, B. T. A., April 6, 1939 (pending C. C. A. 2d); *Millikin* v. *Commissioner*, Memorandum Opinion, B. T. A., June 29, 1939 (pending C. C. A. 6th); *Estate of Stuyvesant* v. *Commissioner*, Memorandum Opinion, B. T. A., July 8, 1939, *Estate of Brant*, Memorandum Opinion B. T. A., April 17, 1939 (pending C. C. A. 6th); cf. *Slack* v. *Commissioner*, 35 B. T. A. 271, petition dismissed, 91 F. (2d) 1011 (C. C. A. 9th).

> pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States;

The authority so conferred "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, 12. The Constitution itself imposes but three restrictions upon the exercise of that power: (1) duties, imposts, and excises must be uniform throughout the United States (Art. I, Sec. 8, cl. 1); (2) direct taxes must be apportioned among the states according to population (Art. I, Sec. 2, cl. 3, and Art. I, Sec. 9, cl. 4); and (3) no tax or duty may be laid upon exports (Art. I, Sec. 9, cl. 5).

Apart from the foregoing restrictions the power to tax is plenary. And it would seem that there could not be any constitutional objection to the imposition of a tax upon income or gains of any kind. Income taxes were levied during the Civil War period, and were regarded as valid. However, in *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601, it was held that a tax upon income derived from property is a direct tax, and therefore is invalid unless apportioned among the states according to population. It is important to note that the Court did not declare Congress to be without any power to impose income taxes; it merely held that certain income taxes are direct, and must be apportioned if they are levied.

The Sixteenth Amendment was adopted in response to the *Pollock* decision. It is not intended as a *limitation* upon the taxing power. It was intended to *expand* the taxing power and to remove the impediment which the majority of the Court thought existed in the *Pollock* case.

Accordingly, it is incorrect to say a tax is "forbidden" by the Sixteenth Amendment. That amendment contains no prohibition or limitation whatever. The plenary power to tax is still conferred by Article I, Section 8, Clause 1, and the Sixteenth Amendment simply implements that power and removes the requirement of apportionment.

If the tax here involved is invalid, its invalidity arises not because Congress has no power to impose a tax upon such gain, but rather because it is a direct tax and must be apportioned among the states in accordance with population—i. e., that the Sixteenth Amendment has merely failed to overcome the objection found in the *Pollock* case. However, it seems clear that a tax upon such gain is valid wholly apart from the Sixteenth Amendment since it is not a direct tax. And in any event the tax is valid since the Sixteenth Amendment was intended "to get rid of nice questions as to what might be direct taxes" (Holmes, J., dissenting in *Eisner* v. *Macomber*, 252 U. S. 189, 220).

CONCLUSION

In every real sense the lessor was enriched and received something new upon the termination of the lease. The gain arising from that transaction was income to him within the meaning of Section 22 (a) and there is no constitutional provision which prohibits the imposition of the tax. The decision below, invalidating the tax, is erroneous and should be reversed.

Respectfully submitted.

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JANUARY 1940.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

Art. 63 [as amended by T. D. 4539, XIV–1 Cum. Bull. 141 (1935)].—*Improvements by lessees.*—If buildings are erected or improvements made by a lessee and such buildings or improvements immediately become the property of the lessor, as, for instance, if they are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income

for each year of the lease an aliquot part thereof.

If the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor shall report income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included.

* * * * * *

Prior to the amendment by T. D. 4539, Article 63 read in full as follows:

ART. 63. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

Except in cases where the lessor has exercised the option to report income upon

basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives no income by reason thereof, and, just as when the lessor comes into possession or control of the property upon the expiration of the lease, the basis for determining gain or loss to the lessor from the subsequent sale or other disposition of the buildings or improvements and for depreciation in respect of such property is the amount previously reported as income by the lessor because of the erection of the buildings or improvements, except that if the buildings or improvements were acquired prior to March 1, 1913, the basis shall be their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. (See articles 130 and 204.)

In all cases where the lessor has exercised the option to report income upon basis (b),

if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise.

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